The Manufacturers Hanover
Economic Report

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Quarterly Business Conditions Analysis

Returning recently from a lengthy business trip, I felt like Rip Van Winkle reincarnated. Washington Irving's legendary character, you may recall, went to sleep one day and did not awaken until 20 years later. When he did, he quite naturally found the world significantly changed from the way it was when he last was awake.

When I embarked on my trip, the business climate was dreary and getting worse at an alarming pace. In an effort to dampen inflation and the expectation of inflation, the Federal Reserve had earlier slammed on the monetary brakes, sending interest rates soaring to record levels and causing consumers to cut back their spending severely in the mistaken belief that credit was no longer available. Needless to say, this caused the "real" gross national product in the second quarter to contract by an annual rate of 9.1 per cent—equal to the worst quarterly decline in the postwar era recorded in first-quarter 1975.

Not surprisingly, many economists, including myself, became alarmed at the rate at which the economy was descending. There were widespread calls for changes in the policy mix, ranging from my recommendation that the Federal Reserve take its foot off the monetary brakes (by removing credit controls and increasing the growth rate of the money supply), to others' views that the government should also step on the fiscal accelerator by cutting taxes and/or increasing spending. Judging by the way the economy appears to be behaving now, I think that the release of the Fed's foot from the monetary brakes may well turn out to be enough. Maybe it's the "Rip Van Winkle" effect, but I detect a distinct change in the economic climate in only about a month's time.

This is not to imply that I think the recession is over, and from here on out the U.S. economy will be expanding. I still believe that we've got several quarters left of economic decline ahead of us. But in terms of the magnitude of the decline as well as the major contributors to it, things will be different in the second half of the year than they were in the second quarter, so you should factor this into your decision-making.

Seeds Of Recovery

Like the plants around the Washington State volcano, Mount St. Helens, that began pushing their way through the ash soon after the eruptions, the seedlings of future economic recovery are popping up now in the wake of the devastation wrought by the second quarter's steep drop in economic activity. For one thing, as consumers stopped spending, they paid off a large chunk of their installment debt and began to rebuild their savings. The decline in consumer credit outstanding in April and May, $5.4 billion, along with the upturn in the second quarter's savings rate to 4.7 per cent from 3.7 per cent in the first quarter, has gone a long way toward returning the consumer's balance sheet to normal.

Ordinarily, such a restoration might have taken several quarters to accomplish, thus prolonging the period during which consumers would stay out of the marketplace. Under those circumstances, of course, business would cut back its operations, laying off workers and adding to the intensity and the duration of the recession. But because many people misunderstood the Fed's credit restraint program, thinking no credit was available at all and that existing obligations should be paid down ahead of schedule, they accomplished this restoration in a matter of months —if not weeks. Thus, when the inevitable price cutting that always follows an unintended buildup of unsold goods got underway, people were able to take advantage of these discounts and step up their pace of spending almost immediately.

You could see this cautious return toward spending in some recent statistics. Sales of single-family homes rose in May compared with April, seasonally adjusted, after having fallen during the previous three months. New-car dealers reported that sales in June did not fall any further from May's levels, sea-

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sonally adjusted—while they actually picked up a bit in early July. The Commerce Department says that housing starts rose sharply in June compared with May, seasonally adjusted, while permits issued for future new-home construction advanced for the second month in a row. Finally, total retail sales advanced in June, both in current dollars and after taking out the effects of inflation.

Much of this change in the economic climate traces to another development that accompanied the steep drop in economic activity: a sharp and unprecedented decline in interest rates. At one point, such key money market interest rates as those on three- and six-month Treasury bills were down ten percentage points from their peaks reached just several months earlier. Such a steep decline has several implications. For one thing, as representatives of the entire spectrum of short-term interest rates, these declines are indicative of an improved availability of credit at lower cost. Obviously, this makes borrowing easier for businessmen and consumers.

In particular, the drop in Treasury bill rates helped the thrift industry by reducing the incentive for people to withdraw their funds from savings accounts and invest them directly in money-market instruments. Known as disintermediation, this process has afflicted the mutual savings banks and savings and loan associations at this point in every postwar business cycle, drying up the funds they have for making mortgage loans. I would not assert at this time that the thrifts are either willing or able to get back into the mortgage-lending business in a big way, but the early reports of renewed deposit inflows, along with the development of such new instruments as the five-year renegotiable mortgage suggest that some further improvement in the pace of residential construction lies ahead.

By taking its foot off the credit brakes in the form of dismantling its program of selective credit controls, the Fed has gone a long way toward helping moderate the economic decline. Early evidence suggests that retail sales are beginning to benefit from the consumer's renewed access to credit. Needless to say, these are largely big-ticket items—the very goods that suffered severely because of earlier cutbacks in consumer spending, then were aggravated by the Fed's credit controls. While rising unemployment may generate continued caution with regard to spending, I think that the renewed availability of credit will begin to tempt people to return to stores to take advantage of the growing number of bargains that is developing as merchants discount prices in an effort to move unsold goods.

This tendency to cut prices has produced a noticeable slowing in the rate of inflation. After rising at a compound annual rate of nearly 17 per cent in the first quarter, consumer prices went up at a more moderate 13½ per cent clip in the second quarter. From the point of view of spurring consumer spending, this slowing of inflation (with some prices actually falling) could not have happened at a better time. This is because the consumer, increasingly aware of the existence of recession, has adopted a new posture distinctly different from the one that he and she have held for the previous two years.

Consumers Change Their Minds

Throughout most of 1978 and 1979, the prevailing attitude among many consumers could best be characterized by the phrase, "buy now before prices go up later." Originally encouraged by the speed with which prices of new cars and new homes went up in spring, 1978, this attitude soon spread to purchases of other goods as people concluded that the government was either unwilling or unable to do anything substantive to slow the rate of inflation, and thus their only recourse was to buy goods before their prices went up. However, the process of buying to beat higher prices must eventually result in people outspending their income flows, causing a cutback in savings. Nationwide, the savings rate plunged from five per cent in 1978 and the early part of 1979 to nearly three per cent by the end of last year. This represented a low equalled only during the early stages of the Korean War, when people rushed to buy goods fearing a repetition of the widespread shortages that characterized World War II.

Many people soon found it expedient to go heavily into debt. They evidently figured that, besides the "benefits" of buying before prices went up, they would be repaying their loans with dollars cheapened by inflation and that the interest rate incurred was a tax deduction, further reducing the effective cost of borrowing. Needless to say, the typical family at yearend 1979 found itself saddled with an unprecedented amount of debt relative to its ability to repay.

At the turn of this year, consumers shifted to a mood of retrenchment in an effort to shore up their savings and reduce their debt burden. This turned into a "buy later" attitude when people saw the effects of the Fed's March 14 policy of credit controls on their own purchases in particular and on the U.S. economy in general. Remembering what happens in every recession, but encouraged especially by the rebates announced by the domestic automobile manufacturers as well as some foreign-based producers, the decline in mortgage interest rates and, subsequently, in new-home prices, people started actively seeking off-price sales among a wide variety of goods and services. By the end of the second quarter, these expectations had begun to bear fruit. As merchants responded to the pileup of unsold goods by slashing prices, consumers responded by returning to stores, producing the rise in retail sales for the month of June that I referred to earlier.

Thus the next few months are likely to bring a dramatic improvement in the inflation rate—at least as measured by the consumer price index. For one thing, recessions always have their effect on inflation for reasons I mentioned above: the widespread discounting that appears whenever unsold goods pile up. This time is no exception, but another reason will be more technical in nature, and that is the way the consumer price index is put together. As should be well known by now, the CPI gives disproportionate weight to new-home prices and mortgage interest rates. When these go up, as they did rapidly from 1978 through the first quarter of this year, they add unduly to the consumer price index, which, in simplistic terms, assumes that everyone buys a new house each month and pays the current mortgage rate to finance it.

Now that mortgage interest rates are falling and housing prices are coming down, there will be a disproportionate downward pull on the CPI, giving the impression that the rate of inflation is slowing. In addition, the consumer price index uses fixed weights, causing energy prices, a fast riser during the last couple of years, to impart more of an upward bias to the CPI than they should have. Because of the aftereffects of the steep rise in energy prices last year as well as the recession, energy supplies have become abundant and retail prices have come down a bit. This, too, should disproportionately slow the rise in the CPI.

Food prices were set to exert a similar downward pull on the CPI until Mother Nature intervened. The well-documented spell of dry, hot weather in the nation's farm belt has taken its toll on many agricultural commodities. It has killed chickens, forced cattlemen to dump their animals onto the market, withered cotton and is beginning to affect the nation's major feed-grain crops. Some retailers already report having to pay higher prices for many types of foods, a situation that undoubtedly will be reflected at the consumer level before very long. In other words, a faster rise in food prices seems likely to moderate some of the downward pull on the CPI exerted by the forces of recession in general and energy and housing in particular. Still, the consumer price index could rise at rates as "low" as 5-6 per cent for at least a few months in the near future before going up more rapidly once again as the economic slide draws to a close.

Inventories Are Swollen Again

When it comes to assessing the position of business inventories, there is much confusion. Inventory data are usually the least reliable of those produced by the government. This is especially so at this point in the business cycle, because current high rates of inflation impact unevenly on inventories and sales. Not too long ago it was fashionable to point out that inventories were in good shape relative to sales, even though the economy was slowing, because the current-dollar ratio of inventories to sales was historically low. However, this has changed in the wake of the steep decline in sales in the past few months. For all business the current-dollar ratio of inventories to sales is now at its highest point since 1976. In "real" terms, taking out the disparate affects of inflation on inventories and sales, the situation is even more worrisome. The I-S ratio for total business is almost as high today as it was during the worst part of the 1973-75 recession.

This may seem to go counter to the prevailing wisdom. Many people would agree that, while there is, indeed, an unintended pileup of inventories, there is not present today the deliberate building up of inventories that occurred in the last cycle. I have no doubt that businessmen have been cautious these past couple of years with regard to inventory levels, since they were given considerable advance notice of this recession and had still in their minds the painful memories of the effects of the deliberate buildup that they undertook during the first half of the last recession. However, I would submit that the real ratio of inventories to sales is as high as it is today because businessmen are once again being misled by inflation, since it affects sales and inventories at different rates of speed.

What this means is that, intent notwithstanding, there exists a substantial overhang of real unsold goods to real sales. This will have to be worked down in the coming months before output can be expected to turn around and rise. Accordingly, you should anticipate that business, through its inventory-reduction policies, will be responsible for the bulk of the economic declines from here on out, in distinct contrast with the downward pull caused by the consumer earlier this year. However, this does not mean that the economic declines likely to occur the current quarter and the fourth quarter will match the second quarter in intensity since, as I pointed out above, the consumer is already back in the marketplace hunting for bargains. This process will aid businessmen on all levels of production and distribution in working down their inventories.

To be sure, the real inventory-sales ratio is a lagging indicator. This means that it usually continues to rise well after a recession comes to an end. In the present circumstance, this suggests that inventory liquidation could continue for some time to come. However, it should be pointed out that changes in the economic climate have occurred with unprecedented swiftness in the current cycle. For example, after rising rapidly late in 1979 and in the first three months of this year, short-term interest rates subsequently fell with equal vigor; after taking on debt at an unprecedented rate late last year and early this year, consumers paid down debt at record-breaking

rates of speed; the drop in many key economic statistics (and the rise in unemployment) was unprecedented in modern times; and the rate of inflation has been cut substantially in the space of three months. What I am saying here is that the inventory-sales ratio could fall just as swiftly as it has gone up because of the combination of increased consumer buying and rapid declines in output. If so, it would reduce the time needed to get stocks in line with sales.

With automobiles and housing now on the way up, and retail trade in general likely to experience increases before too many months go by, it would seem that the economy should reach its nadir around yearend. Thus, 1981 should, by and large, be a year of expanding economic activity. However, lest you get your hopes up high, let me go down on record as saying that I do not believe that the expansion, when it comes, will be all that noticeable because it will not be all that sharp.

The Rebound Will Be Mild

There are several reasons for this. In the private sector, the consumer, having satisfied his and her demands for goods ahead of schedule for the last couple of years is likely to return to a more normal pace of buying in the next couple of years. The demographics of the population may suggest that there is pent-up demand for autos, housing and other big-ticket items, but the very nature of these goods (their postponable quality) makes it difficult to predict flatly when these pressures will generate a renewed burst of spending.

On the business side, because capacity utilization has sunk so low and because large sums of money still must be earmarked for such noncyclical purposes as cleaning up the environment, making plants safer for workers and goods safer for consumers, and because the tax structure continues to weigh against capital formation, business is unlikely to embark on a capital spending boom any time soon. On the monetary side, the Federal Reserve at best will follow its recent path of keeping the growth in the money and credit aggregates to a rate which over the long run would tend to squeeze down inflation. At worst, the Fed could return wholeheartedly to its policy of managing money-market interest rates which, given present depressed conditions, would tend to keep the supply of money and credit growing even more slowly, thus putting more of a lid on the eventual economic rebound.

It is on the fiscal side that the greatest restraint is likely to occur. Right now there is much discussion of the need for a tax cut. Such discussions are not hard to understand, since cutting taxes puts more money into people's pockets, presumably encouraging them to increase their outlays, thus ending the recession. However, because of special circumstances that prevail at this time, there is a need to distinguish between actually cutting taxes and simply reducing the tax burden. For unless taxes are cut by substantially more than is now being discussed, the actual tax burden on most people will rise significantly in 1981.

There are several reasons for this. The first is the fact that inflation pushes us all into higher tax brackets. Since our tax structure is "progressive," a higher tax bracket means a higher tax rate (percentage of income). With no change in present tax rates, the upward warp brought about by inflation will produce an extra $20 billion in Federal revenues next year. Then there is the projected increase in Social Security taxes. Under present law, Social Security taxes will go up by $17 billion on January 1. The reason for this rise is that Social Security taxes must cover the increased benefits that the system pays out, and benefits have risen sharply in recent years because they are indexed to the rate of inflation. Add to this the $15 billion or so that the government is likely to take in next year because of the "windfall" profits tax on the oil companies, and you come out with an increase in the tax burden exceeding $50 billion, if present laws remain unchanged.

This kind of tax increase would restrain significantly the economy's ability to recover from today's recession. It might keep unemployment high for a considerable period of time and sales and profits sluggish. However, if there are signs that the recession has bottomed out by the turn of the year and a recovery is underway, policymakers might be wise to avoid cutting taxes at all. This is because of the long-run considerations of balancing the budget which must still be kept in mind. Plainly, the more taxes are cut and/or spending increased, the further away we will move from the path of a balanced budget. And as I have said time and again, the only way we are going to make any fundamental progress against inflation is for Washington to balance its books so that the Federal Reserve can keep the growth rate of money and credit down to a rate not exceeding the economy's ability to produce real goods and services.

All of this goes back to what I said in the June Report. What may appear to be bad economics (and even worse politics) for the shorter run, makes a good deal of sense, longer run. I think we should not only recognize that 1981's recovery will be slow, we should not do anything to offset this, so that we can continue working toward that elusive but necessary balanced budget, now a hopeful target for 1982. We have an opportunity to ensure a bright future for the longer run—provided we consider the long run in setting economic policy. H

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July, 1980

MHT FORECAST OF GROSS NATIONAL PRODUCT

(Seasonally Adjusted Annual Rates)

In $ Billions

	< Actual				Projected >							
	1979		YEAR 1979		1980				YEAR 1980		1981	
	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II
Gross National Product	2396.5	2456.9	**2368.8**	**11.3**	2520.8	2523.4	2531.4	2558.2	**2533.5**	**7.0**	2611.4	2666.8
GNP: $72	1433.3	1440.3	**1431.6**	**2.3**	1444.7	1410.8	1392.9	1383.4	**1408.0**	**−1.7**	1389.9	1400.7
% Change, Annual Rates	3.1	2.0	**2.3**		1.2	−9.1	−5.0	−2.7	**−1.7**		1.9	3.2
Consumption	1528.6	1580.4	**1509.8**	**11.8**	1629.5	1628.2	1648.1	1663.9	**1642.4**	**8.8**	1694.1	1722.0
Durables	213.4	216.2	**213.0**	**6.4**	220.2	197.0	198.2	198.3	**203.4**	**−4.5**	206.6	213.1
Non-Durables	604.7	630.7	**596.9**	**12.5**	652.0	654.4	657.5	674.0	**659.5**	**10.5**	688.4	691.7
Services	710.6	733.5	**699.9**	**12.9**	757.3	776.8	792.4	791.5	**779.5**	**11.4**	799.1	817.2
Investment	392.3	387.2	**387.2**	**10.1**	387.7	366.9	340.7	339.1	**358.6**	**−7.4**	354.8	374.5
Non-Residential	261.8	265.2	**254.9**	**15.3**	272.6	265.9	263.2	263.1	**266.2**	**4.4**	263.4	261.3
Producers Durable Equipment	166.7	165.0	**162.2**	**12.2**	169.4	163.2	163.6	164.1	**165.1**	**1.8**	165.0	167.6
Structures	95.0	100.2	**92.6**	**21.1**	103.3	102.7	99.6	98.9	**101.1**	**9.1**	98.4	93.7
Residential	116.0	116.4	**114.1**	**5.6**	110.4	89.3	88.8	91.4	**95.0**	**−16.8**	101.2	115.3
Inventory Changes	14.5	5.6	**18.1**		4.7	11.7	−11.3	−15.4	**−2.6**		−9.8	−2.1
Net Exports	−2.3	−11.9	**−4.6**		−13.6	1.3	0.6	2.9	**−2.2**		−3.1	−5.3
Government Purchases	477.8	501.2	**476.4**	**9.4**	517.2	527.0	542.1	552.3	**534.7**	**12.2**	565.5	575.5
Federal Defense	109.0	114.6	**108.3**	**9.3**	119.6	123.6	128.6	135.2	**126.8**	**17.1**	140.9	146.8
Federal Civilian	53.9	63.8	**58.4**	**9.0**	66.6	68.9	72.1	71.0	**69.7**	**19.3**	72.3	73.4
State & Local	314.9	322.8	**309.8**	**9.5**	331.0	334.5	341.4	346.1	**338.3**	**9.2**	352.3	355.3
Final Sales: $72	1426.2	1439.0	**1421.9**	**2.7**	1444.4	1408.5	1401.6	1392.5	**1411.8**	**−0.7**	1394.0	1401.9
% Change, Annual Rates	6.4	3.6	**2.7**		1.5	−9.6	−1.9	−2.6	**−0.7**		0.4	2.3
GNP Price Index (1972 = 100)	167.2	170.6	**165.5**	**8.9**	174.5	178.9	181.7	184.9	**180.0**	**8.8**	187.9	190.4
% Change, Annual Rates	8.5	8.3	**8.9**		9.5	10.4	6.6	7.2	**8.8**		6.6	5.4
PCE Deflator (1972 = 100)	165.1	169.0	**163.3**	**8.9**	174.0	178.2	181.6	184.9	**179.7**	**10.0**	188.5	191.3
% Change, Annual Rates	9.8	9.8	**8.9**		12.4	10.0	7.7	7.7	**10.0**		7.9	6.1
Consumer Price Index (1967 = 100)	220.8	228.0	**217.6**	**11.3**	237.1	244.8	249.4	253.2	**246.1**	**13.1**	257.2	261.4
% Change, Annual Rates	13.4	13.6	**11.3**		16.9	13.7	7.7	6.2	**13.1**		6.6	6.6
Total Personal Income	1946.6	2005.0	**1924.2**	**12.0**	2057.4	2078.3	2101.9	2141.6	**2094.8**	**8.9**	2168.2	2197.4
Disposable Personal Income	1640.0	1683.1	**1624.3**	**11.4**	1737.4	1754.0	1779.8	1812.1	**1770.8**	**9.0**	1850.5	1873.3
Savings Rate	4.3	3.5	**4.5**		3.7	4.7	5.1	6.0	**4.9**		6.3	5.8
Employment Rate	58.4	58.4	**58.3**		58.3	57.6	57.2	56.8	**57.5**		56.7	56.9
Unemployment Rate	5.8	5.9	**5.8**		6.1	7.5	7.9	8.6	**7.5**		8.9	8.7
Indus. Production (1967 = 100)	152.3	152.2	**152.1**	**4.1**	152.2	144.7	139.4	138.1	**143.6**	**−5.6**	139.8	142.7
Housing Starts (000)	1808.7	1593.3	**1721.9**	**−14.3**	1263.3	1044.7	1227.1	1302.5	**1209.4**	**−29.8**	1513.7	1698.8
Domestic Auto Sales (000)	8633.3	7500.0	**8375.0**	**−9.9**	7933.3	5504.0	5963.6	6309.3	**6427.6**	**−23.3**	6879.9	7115.8
Corporate Pre-Tax Profits	242.3	243.0	**236.6**	**14.9**	260.4	203.8	192.4	182.7	**209.8**	**−11.3**	173.0	186.6
− Taxes	94.0	96.1	**92.5**	**9.5**	102.4	80.1	75.6	71.8	**82.5**	**−10.9**	58.4	63.1
Net Profits	148.3	146.9	**144.1**	**18.6**	158.0	123.7	116.8	110.9	**127.4**	**−11.6**	114.6	123.5
− Dividend Payments	52.8	54.4	**52.8**	**11.9**	56.7	58.6	59.8	59.6	**58.7**	**11.2**	59.4	60.5
Undistributed Profits	95.5	92.5	**91.4**	**22.9**	101.3	65.1	57.0	51.3	**68.7**	**−24.5**	55.2	63.0
+ Depreciation	132.8	135.2	**131.0**	**9.3**	137.4	139.3	145.7	149.6	**143.0**	**9.2**	156.6	160.2
− Inventory Profits	44.0	46.5	**41.8**	**65.7**	63.2	27.8	30.8	30.5	**38.1**	**−8.8**	33.4	35.7
Net Cash Flow	184.3	181.2	**180.6**	**6.9**	175.5	176.6	171.9	170.4	**173.6**	**−3.7**	178.4	187.5